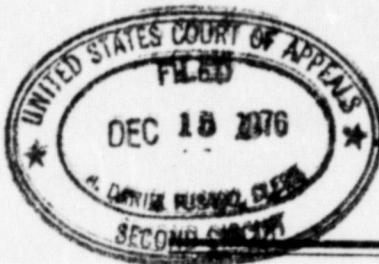


*United States Court of Appeals
for the Second Circuit*



APPELLEE'S BRIEF



76-7462

To be argued by
DENNIS J. BLOCK

United States Court of Appeals
For the Second Circuit

DOMACO VENTURE CAPITAL FUND, a limited partnership,
Plaintiff-Appellant,
against

TELTRONICS SERVICES, INC., SHASKAN & CO., INC., CLAUDE C. CONTI, EDWARD M. BEAGAN, THOMAS R. RAMSEY, DAVID A. LA CONTE, GERARD F. HUG, GILBERT MONICK and JEFFREY A. MOROSS,

Defendants,

TELTRONICS SERVICES, INC., EDWARD M. BEAGAN, DAVID A. LA CONTE, GERARD F. HUG and GILBERT MONICK,
Defendants-Appellees.

**On Appeal from the United States District Court
for the Southern District of New York**

BRIEF OF DEFENDANTS-APPELLEES

WEIL, GOTSHAL & MANGES
Attorneys for Defendants-Appellees
767 Fifth Avenue
New York, New York 10022
(212) 758-7800

Of Counsel:

DENNIS J. BLOCK
JAMES W. QUINN
LYNN H. SCHAFRAN

TABLE OF CONTENTS

| | <u>Page</u> |
|--|-------------|
| TABLE OF AUTHORITIES | ii |
| ISSUES PRESENTED | 1 |
| PRELIMINARY STATEMENT | 2 |
| STATEMENT OF FACTS | 6 |
| ARGUMENT | |
| I. THIS COURT LACKS JURISDICTION OVER THE SUBJECT MATTER OF THIS APPEAL | 16 |
| II. THE COURT BELOW PROPERLY FOUND APPELLANT TO BE AN INADEQUATE REPRESENTATIVE OF THE CLASS | 18 |
| A. Appellant's Conflicts With And Different Interests From Those It Purports To Represent Show That Its Claims are Atypical, And That It Is An Inadequate Representative Of Any Class. | 20 |
| B. The Cases Relied Upon By Appellant Are Eitner Inapposite Or Support Appellees' Contention Of Inadequacy. | 29 |
| III. APPELLANT'S FEE ARRANGEMENT AND CLOSE ASSOCIATION WITH ITS COUNSEL ACT AS INDEPENDENT REASONS FOR ITS DISQUALIFICATION AS CLASS REPRESENTATIVE | 35 |
| A. Maintenance | 35 |
| B. Multiple Clients With Differing Interests. | 40 |
| IV. APPELLANT CANNOT ESTABLISH THAT COMMON QUESTIONS OF LAW OR FACT PREDOMINATE OVER INDIVIDUAL QUESTIONS AS REQUIRED BY RULE 23(b)(3) | 42 |
| CONCLUSION | 45 |

TABLE OF AUTHORITIES

| Cases: | Page |
|---|-------------------|
| <u>Adise v. Mather</u> , 56 F.R.D. 492. (D. Colo. 1972) | 14 |
| <u>Alpert v. U.S. Industries, Inc.</u> , 59 F.R.D. 491 (D.C. Cal. 1973) | 27 |
| <u>Anschul v. Sitmar Cruises, Inc.</u> , F.2d , 21 Fed.R.Serv.2d 946 (7th Cir. May 17, 1976) | 16 |
| <u>Blue Chip Stamps v. Manor Drug Stores</u> , 421 U.S. 723 (1975) | 3 |
| <u>Caceres v. International Air Transport Association</u> , 422 F.2d 141 (2d Cir. 1970) | 16 |
| <u>Carroll v. American Federation of Musicians</u> , 372 F.2d 155 (2d Cir. 1967) | 21 |
| <u>Cook Investment Co. v. Harvey</u> , 195,203 CCH Fed. Sec. L. Rptr. (N.D. Ohio 1975) | 33 |
| <u>Cotchett v. Avis Rent A Car System, Inc.</u> , 56 F.R.D. 549 (S.D.N.Y. 1972) | 27 |
| <u>Daye v. Pennsylvania</u> , 344 F. Supp. 1337 (E.D. Pa. 1972), <u>aff'd</u> 483 F.2d 294 (3rd Cir. 1973), <u>cert. denied</u> , 416 U.S. 946 (1974) | 23 |
| <u>Dolgow v. Anderson</u> , 43 F.R.D. 472 (S.D.N.Y. 1968) <u>rev'd on other grounds</u> , 438 F.2d 825 (2d Cir. 1970) | 21 |
| <u>Dorfman v. First Boston Corp.</u> , 62 F.R.D. 466 (E.D. Pa. 1974) | 18, 33 |
| <u>du Pont v. Perot</u> , 59 F.R.D. 404 (S.D.N.Y. 1973) | 20, 22 |
| <u>du Pont v. Wyly</u> , 61 F.R.D. 615 (D. Del. 1973) | 21, 22, 25, 31 |
| <u>Eisen v. Carlisle & Jacquelin</u> , 479 F.2d 1005 (2d Cir. 1973) | 18 |
| <u>Eisen v. Carlisle & Jacquelin</u> , 417 U.S. 156 (1974) | 36 |
| <u>First American Corporation v. Foster</u> , 51 F.R.D. 248 (N.D. Ga. 1970) | 30 |

| Cases: | Page |
|--|-------------------|
| <u>Frederick Norman, D.D.S., P.C. Employee Pension Fund v. Arcs Equities, F. Supp. , Docket No. 75 Civ. 4391 (S.D.N.Y. July 2, 1976)</u> | 36 |
| <u>G.A. Enterprises, Inc. v. Leisure Living Communities, Inc., 517 F.2d 24 (1st Cir. 1975)</u> | 4, 20, 26, 31, 34 |
| <u>Gonzalez y Barredo v. Schenck, 287 F.Supp. 505 (D.C.N.Y. 1968)</u> | 39 |
| <u>Hawk Industries, Inc. v. Bausch & Lomb, Inc., 59 F.R.D. 619 (S.D.N.Y. 1973)</u> | 40 |
| <u>Hettinger v. Glass Speciality Co., 59 F.R.D. 286 (N.D. Ill. 1973)</u> | 21, 27 |
| <u>Hornreich v. Flant Industries, Inc., 535 F.2d 550 (9th Cir. 1976)</u> | 26 |
| <u>Horwitz v. Panhandle Eastern Pipe Line Co., 293 F. Supp. 1092 (W.D. Okla. 1968)</u> | 23 |
| <u>Ingenito v. Bermac Corp., CCH Fed. Sec. L. Rep. 194,548 (S.D.N.Y. 1974)</u> | 44 |
| <u>In re Go Chip Funding Co., 61 F.R.D. 592 (E.D. Pa. 1974)</u> | 22, 23 |
| <u>In the Matter of Gilman, 251 N.Y. 265 (1929)</u> | 39, 40 |
| <u>Johnson v. American General Insurance Co., 296 F. Supp. 802 (D.D.C. 1959)</u> | 23 |
| <u>Korn v. Franchard, 456 F.2d 1206 (2d Cir. 1972)</u> | 35 |
| <u>Lah v. Shell Co., 50 F.R.D. 198 (S.D. Ohio 1970)</u> | 27 |
| <u>Lamb v. United Security Life Company, 59 F.R.D. 25 (S.D. Iowa 1972)</u> | 29 |
| <u>Lawrence v. Commodore Navigation Corp., 108 F.2d 563 (2d Cir. 1940)</u> | 39, 40 |
| <u>Lester v. Preco Industries, Inc., 282 F. Supp. 459 (S.D.N.Y. 1965)</u> | 3 |

| Cases: | Page |
|---|--------|
| <u>Madonick v. Denison Mines Ltd.</u> , 63 F.R.D. 657 (S.D.N.Y. 1974) | 32 |
| <u>Maynard, Merel & Co. v. Carcioppolo</u> , 51 F.R.D. 273 (S.D.N.Y. 1970) | 30, 45 |
| <u>Mersay v. First Republic Corp.</u> , 43 F.R.D. 465 (S.D.N.Y. 1968) | 30 |
| <u>Milberg v. Western Pacific R.R.</u> , 443 F.2d 1301 (2d Cir. 1971) | 16 |
| <u>Morris v. Burchard</u> , 51 F.R.D. 530 (S.D.N.Y. 1971) | 44 |
| <u>Moscarelli v. Stamm</u> , 288 F. Supp. 453 (E.D.N.Y. 1968) | 44 |
| <u>National Auto Brokers Corp. v. General Motors Corp.</u> , 60 F.R.D. 476 (S.D.N.Y. 1973) | 21 |
| <u>Odette v. Shearson, Hammill & Co., Inc.</u> , 1974-75 CCL Sec. L. Rptr. ¶95,038 (S.D.N.Y. 1975) | 13 |
| <u>Parkinson v. April Industries</u> , 520 F.2d 650 (2d Cir. 1975) | 16 |
| <u>Polak v. Noel Industries, Inc.</u> , 64 F.R.D. 333 (S.D.N.Y. 1974) | 15, 28 |
| <u>Reichlin v. Wolfson</u> , 47 F.R.D. 537 (S.D.N.Y. 1969) | 30 |
| <u>Ruggiero v. American Bioculture, Inc.</u> , 56 F.R.D. 93 (S.D.N.Y. 1972) | 21, 40 |
| <u>Sayre v. Abraham Lincoln Federal Savings & Loan Assoc.</u> , 19 F.R. Serv.2d 311 (E.D. Pa. 1974) | 35 |
| <u>Schein v. Chasen</u> , 478 F.2d 817 (2d Cir. 1973), vacated and remanded on different grounds, 416 U.S. 386 (1974) | 12 |
| <u>Shapiro v. Merrill Lynch, Pierce, Fenner & Smith</u> , 495 F.2d 228 (2d Cir. 1974) | 12 |

| Cases: | Page |
|--|------------------------------|
| <u>Shayne v. Madison Square Garden Corp.</u> , 491 F.2d 397 (2d Cir. 1974) | 17 |
| <u>Simon v. Merrill Lynch, Pierce, Fenner & Smith, Inc.</u> , 16 F.R. Serv. 2d 1021 (N.D. Texas 1972) | 35 |
| <u>Skydell v. Mates</u> , CCH Fed. Sec. L. Rep. 193,538 (S.D.N.Y. 1972) | 44 |
| <u>Slack v. Stiner</u> , 358 F.2d 65 (5th Cir. 1966) | 23 |
| <u>Stavrides v. Mellon Nat'l. Bank & Trust Co.</u> , 60 F.R.D. 634 (W.D. Pa. 1973) | 35 |
| <u>Taub v. Glickman</u> , 14 F.R. Serv. 2d 847 (S.D.N.Y. 1970) | 35 |
| <u>Traylor v. Marine Corp.</u> , 328 F. Supp. 382 (E.D. Wisc. 1971) | 23, 24 |
| <u>Umbriac v. American Snacks, Inc.</u> , 388 F. Supp. 265 (E.D. Pa. 1975) | 32 |
| <u>Ungar v. Dunkin' Donuts of America, Inc.</u> , 531 F.2d 1211 (3rd Cir. 1976) | 16 |
| <u>Vernon J. Rockler & Co. v. Graphic Enterprises, Inc.</u> , 52 F.R.D. 335 (D. Minn. 1971) | 21, 29 |
| <u>Victorian Investors v. Responsive Environments Corp.</u> , 56 F.R.D. 543 (S.D.N.Y. 1972) | 27 |
| Statutes: | |
| 29 McKinney's Judiciary Law §488 | 39 |
| 28 U.S.C. §1291 | 16 |
| 28 U.S.C. §1292(b) | 16 |
| Rules: | |
| Fed. R. Civ. P. 23 | 5, 20, 30, 31, 32, 42, 43 |
| SEC Rule 10b-5 | 24 |

| | Page |
|---|-------------|
| Other Authorities: | |
| Advisory Committee Notes, 39 F.R.D. 69 (1966) | 43 |
| ABA Canons of Professional Ethics (1908, as amended), Canon 42 | 38 |
| Code of Professional Responsibility N.Y. | 37, 38, 39, |
| | 41, 42 |
| Preliminary Statement | |
| Canon 1 (DR 1-102[A][1]); | |
| Canon 5 (EC 5-1, 5-7, 5-8, 5-14, 5-15, 5-16); (DR 5-103[B], 5-105[B]); | |
| Canon 6, Judiciary Law Appendix | |
| 3B Moore, <u>Federal Practice</u> , ¶¶23.06-2, 23.07[1] | 20, 22 |
| 7A Wright & Miller, <u>Federal Practice and</u> <u>Procedure</u> , ¶¶1765, 1766, 1802 (1972) | 15, 21, 22 |

ISSUES PRESENTED

1. Does this Court have jurisdiction over the subject matter of this appeal from the denial of class action status below where, even absent review, the death knell of this case has not sounded?
2. Did the District Court properly deny class action status upon a finding that the dual role of the real-party-in-interest plaintiff renders appellant an inadequate representative of any alleged class?
3. Should this Court permit class action status where the improper fee arrangement between the real-party-in-interest plaintiff and his counsel raises clear conflict of interest and other ethical problems?
4. Should this Court permit class action status where common questions of law or fact cannot predominate over individual questions on account of the inconsistent treatment of certain putative class members and individualized oral conversations by the real-party-in-interest plaintiff?

Preliminary Statement

This is an appeal by Domaco Venture Capital Fund ("Domaco Fund") from a Memorandum and Order entered below on August 10, 1976 (J.A. 249)* by District Judge John M. Cannella denying appellant's motion made pursuant to Rule 23 of the Federal Rules of Civil Procedure for designation as a class representative.

The court below in rejecting class status found that the real-party-in-interest was Jack Polak, appellant's investment advisor and controlling force and held that:

"Treating Polak and Domaco Fund as one for the purpose of this motion, there are three possible bases for rejecting Polak as the named plaintiff: (1) As a result of the third-party complaint Polak faces liability himself and is therefore subject to pressures which may cause him to protect his interests to the detriment of the interests of the class; (2) Polak plays a 'dual role' as class representative and the individual responsible for certain class members having purchased Teltronics; (3) Polak may be subject to a claim that he was a tippee by those class members he did not represent in his securities business." (J.A. 253-254).

Appellant would have this Court ignore these clearly stated multiple bases for the rejection of appellant as a putative class representative and believe instead that the

* All references herein to the Joint Appendix are designated "J.A.", to the Supplementary Appendix are designated "S.A.", to Appellant's Brief are designated "App. Br." and to Judge Cannella's Memorandum and Order are designated "Opinion" and are thereafter cited to the appropriate J.A. page.

District Court's "decision ... below is based upon pure fiction" (App. Br. 5) and is the result of contrived counter-claims which appellees have no bona fide intention of pursuing (App. Br. 13). Such rhetoric flies in the face of the District Court's express factual findings and is an effort to deflect this Court's attention from Polak's insoluble conflict with the alleged class as reflected in the record. Appellant's charges, like its entire brief (which contains not a single citation to the record below), are based entirely on bare-boned denials which are contradicted by the undisputed facts.

Indeed, the only manufactured claims in this suit are contained in the Complaint (J.A. 5), which even if true could not amount to fraud.* Rather those claims reveal this case to be the archetypal strike suit of the kind inveighed against by the United States Supreme Court in Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 740 (1975):

* For example, the Complaint alleges that the Prospectus failed to disclose that not all of the directors of appellee Teltronics Services, Inc. ("Teltronics") agreed with one another on every issue (Complaint ¶15(c), J.A. 10); or that Teletronics intended to use a portion of the offering proceeds for manufacturing purposes (Complaint ¶15(a) and (b), J.A. 9). Such claims are frivolous on their face -- the first charge hardly amounts to fraud under the federal securities laws; the second was expressly rejected as a ground for recovery in Lester v. Preco Industries, Inc., 282 F. Supp. 459, 464 (S.D.N.Y. 1965).

"... in the field of federal securities laws governing disclosure of information even a complaint which by objective standards may have very little chance of success at trial has a settlement value to the plaintiff out of any proportion to its prospect of success at trial..."

That complaint and the record below demonstrate that Polak's motive for bringing this suit in the first place was to insulate himself from claims by members of the putative class for whom he invested in Teltronics stock and other putative class members to whom he may be liable as a tippee. Yet, when just such claims are asserted against him by Teltronics, Polak claims "foul" and asks this Court to treat them as a sham. He would have appellees sit on their rights while he goes forward with a class action to protect himself from liability. This is precisely the kind of "leverage" the court below and the First Circuit in G. A. Enterprises, Inc. v. Leisure Living Community, Inc.* sought to avoid by denying class status.

At the threshold, the decision below denying class status is not appealable where, as here, the record demonstrates that the so-called "death knell" doctrine is inapplicable (Point I, infra). Even if this Court were to entertain this appeal, the fact is the decision of the District

* 517 F.2d 24, 26 (1st Cir. 1975).

Court and the claims raised by appellees are firmly grounded in the record, which is replete with evidence of Polak's dual role and supports both appellee's contribution claims and Judge Cannella's fear that the class action might be "leveraged" by Polak's conduct in protecting his own interests (Opinion, J.A. 255) (Point II, infra). Moreover, the admissions of maintenance by appellant and his counsel standing alone demonstrate appellant's inadequacy as a class representative and bar class status here (Point III, infra). Finally, Polak's inconsistent treatment of putative class members and his individualized conversations coupled with antagonisms inter se among class members make it evident that no class can exist as defined here because class members' common questions of law or fact do not predominate here over individual questions as required by Rule 23(b)(3) (Point IV, infra).

STATEMENT OF FACTS

This is a garden variety securities case involving alleged misrepresentations and omissions in the January 9, 1973 Prospectus of appellee Teltronics*. Appellant sought below to represent a class estimated at between 250 and 300 investors, consisting of all purchasers of Teltronics stock between January 3, 1973 and April 9, 1973 who allegedly bought stock in reliance upon the Prospectus. Appellees opposed the class motion below on the grounds that appellant and its counsel are improper class representatives for several independent reasons and that non-common legal and factual issues preclude the granting of class status. The court below agreed with appellees and denied class status.

The following facts, most of which were uncovered during the course of the limited discovery conducted by appellees with respect to the class motion, and many of which were found to be undisputed by the court below (Opinion J.A. 250-251), or are conceded by appellant on this appeal (App. Br. 2-3) are relevant to the class issue. These are the same facts upon which Judge Cannella based his opinion and out of which Teltronics' counter, cross and third party claims (as

* Teltronics is a New York corporation engaged in selling, installing and servicing telephone equipment for inter-connection into telephone lines leased from regulated telephone companies (J.A. 172). Appellees Edward M. Beagan, David A. LaConte, Gerard F. Hug and Gilbert Monick are all present or former officers of Teltronics (J.A. 8).

well as the claims of the putative class members) arise. Appellant's flippant discussion of the theory underlying these claims (App. Br. 3-6) ignores the fact that the District Court's findings of appellant's conflicting interests and vulnerability to suit are firmly grounded in the record in this case, particularly in the many admissions made by Polak and his counsel at Polak's deposition.

Appellant Domaco Fund is a New York limited partnership and closed-end investment company which has 19 limited partners (Opinion, J.A. 250). However, as the court below expressly found, the real party-in-interest in this action is Jack Polak, an investment advisor who controls and is the sole general partner in Domaco Company ("Domaco"), which in turn is the sole general partner in appellant Domaco Fund (Opinion, J.A. 250; App. Br. 3).

Polak is an experienced investment advisor who invests money for others on a completely discretionary basis through his company, Equity Interest, Inc. ("Equity") which is registered with the Securities and Exchange Commission as an investment advisor (J.A. 87, 88). Polak, in his individual capacity and as president of Equity is the sole investment advisor for Domaco Fund (Opinion, J.A. 250; App. Br. 3). He has approximately 160 clients who give him discretionary trading authority to execute transactions in their brokerage accounts (Opinion, J.A. 250); he manages approximately \$2.5

million, although the value of the accounts he manages has declined steadily since 1969 (J.A. 88, 99). Polak testified that he generally purchases new issues and over-the-counter stocks for his clients (e.g., J.A. 130), that he often personally receives stock at little or no cost to himself, or cash as so-called "consultant fees" from these companies without actually disclosing such consultant fees to his clients (J.A. 98, 99); and that although he never received any payments from Teltronics, he did request that he be placed on its Board of Directors just two weeks prior to the filing of the Complaint herein (J.A. 206, 208).

Appellant admits that Polak "had a long standing relationship" with Stanley Bartels (App. Br. 3), a principal of the now defunct broker-dealer Shaskan & Co., Inc. ("Shaskan"), which is also a defendant in this action. The court below specifically found that Shaskan was the main market maker in Teltronics stock during the relevant period, that Polak is and was a close friend of Bartels, and that Bartels executed most, if not all, of the transactions that Polak brought to Shaskan. (Opinion, J.A. 251). In addition, the record discloses that Polak was one of Bartel's major clients at Shaskan and has remained close friends with and a client of Bartels even after Shaskan's financial collapse in June 1973 (J.A. 144, 145),*

* As found by the District Court, Shaskan went out of business on June 20, 1973 (Opinion, J.A. 251).

that Bartels serviced sixty of Polak's accounts, as well as Polak's personal account, totalling approximately \$500,000 (J.A. 144, 146), and that Polak's clients got all of Shaskan's new issues (J.A. 146).

The District Court also found that Bartels had numerous conversations with Polak about Teltronics as an investment possibility (Opinion, J.A. 251). Polak himself testified that during the conversations prior to the purchases of Teltronics stock, "Mr. Bartels told me great things about Teltronics, about the industry, about the management" (J.A. 171) and that Bartels made various representations to him concerning Teltronics' financial condition and earnings potential (J.A. 171-172). Further, Polak admitted that in purchasing new issues he relied on "the additional information given to me by the broker who issued the stock in question and Teltronics was the same way" (J.A. 181).

After these conversations, between January 9, 1973 and January 11, 1973, Polak purchased Teltronics stock for 50 of his clients, including the named plaintiff-appellant Domaco Fund (Opinion, J.A. 244-245, 251).

As early as May 1973 Polak had conversations with Bartels concerning Shaskan's financial difficulties (J.A. 229). Polak admittedly relied on Shaskan as the prime market maker for Teltronics (J.A. 201) and he was certainly aware that the market price of Teltronics stock was bound to decline in the

event that its prime market maker collapsed. The record discloses that prior to Shaskan's collapse in June 1973, Polak sold Teltronics stock for certain of his clients, while not selling out others, including appellant Domaco Fund (J.A. 72-74). Polak and his counsel refused to explain the reason why these shares were sold or why when Polak learned of the alleged misrepresentations in the Prospectus he sold Teltronics stock for only certain of his clients (J.A. 211-216).*

Based on this record, Teltronics believes that, even prior to appellant's purchase of stock on January 9, 1973, Shaskan and Bartels gave Polak certain improper and unlawful assurances and guarantees limiting Polak's clients' losses in the event that the price of Teltronics stock declined (Counterclaim ¶14, J.A. 46); that Bartels and Shaskan made representations outside the Prospectus regarding the potential for price appreciation of Teltronics common stock, the Teltronics management, the potential of Teltronics in the "interconnect" business, and the earnings expectations for Teltronics during its first year as a public company (Counterclaim ¶13, J.A. 46); and that Polak made an independent investigation of Teltronics and its securities (Counterclaim ¶15, J.A. 47). Teltronics contends that appellant Domaco Fund and

* Prior to June 19, 1973 Polak sold Teltronics stock for 33 of the approximately 50 accounts he managed that held Teltronics stock, including four individual accounts of limited partners of Domaco Fund (J.A. 72-74).

certain other members of the class whom Polak induced and/or caused to purchase Teltronics stock never relied on the Prospectus in purchasing Teltronics stock or on any of the alleged misrepresentations and omissions alleged in the Complaint (Counterclaim ¶¶31-43, J.A. 52-55). Subsequent to the purchases of its stock, Teltronics alleges that Polak, through his contacts with Bartels and Shaskan and in accordance with their previous assurances and guarantees, learned material inside information concerning the troubled financial condition of Shaskan (Counterclaim ¶¶17 and 18, J.A. 48), and based on such material inside information, Polak caused certain of his clients (who are members of the putative class) to sell Teltronics stock (Counterclaim ¶22, J.A. 49).

While these same record facts are concededly the basis for Teltronics' counter, cross and third-party claims against Polak and others, they may also be the basis for claims of Polak's own clients and other potential class members against him. It is apparent from the record in this action that Polak, acting through appellant Domaco Fund, has commenced this action in an effort to insulate himself from just such claims. And the existence of those claims, coupled with the significant intra-class claims which may exist inter se among various putative class member groups (and the non-common issues generated by such potential antagonisms) render appellant Domaco Fund an inadequate representative and make the case

itself inappropriate for class action treatment.

Under any analysis some or all of the potential class members possess at least four separate types of claims against Polak and/or Domaco Fund and/or inter se against other class members:

1. Purchasers of Teltronics stock who were not Polak's clients may have securities claims against Polak, Domaco Fund, Domaco, Equity (sometimes hereinafter referred to as "the Polak defendants") and others, including Polak's clients who were purchasers, for damages arising out of the alleged scheme to limit losses in Teltronics stock, and for failure to disclose material inside information to such non-client purchasers. Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974).

2. Those same purchasers as well as some of Polak's own clients may have securities claims against the Polak defendants, including the remainder of his purchaser-clients, for the sales made prior to Shaskan's collapse in June 1973 allegedly based on this failure to disclose material inside information. Id.

3. Those pre-Shaskan collapse purchasers (whether or not clients of Polak) who are presently holders of Teltronics stock may have securities claims against the Polak defendants and others arising out of Shaskan's failure to disclose material inside information to Teltronics. Schein v. Chasen,

478 F.2d 817 (2d. Cir. 1973), vacated and remanded on different grounds, 416 U.S. 386 (1974).

4. Those purchasers who were Polak's clients may also have claims against Polak and others for breach of his statutory and common law fiduciary duties arising out of their purchases of Teltronics stock, notwithstanding Polak's knowledge of the alleged facts, misleading statements and omissions upon which appellant now sues. Odette v. Shearson, Hammill & Co., Inc., 1974-75 CCH Sec. L. Rptr. ¶95,038 (S.D.N.Y. 1975).

The existence of these potential claims is real -- not mere speculation. Indeed, Teltronics has already sued the Polak defendants, including appellant, seeking contribution and money damages based on many of these claims and others (Counter-claim ¶¶31-57, J.A. 52-58). As found by the District Court, in light of these pending and other potential claims, the law set forth infra is clear that Polak, acting through the Domaco Fund, cannot properly represent any class since his interests and those of appellant are not coextensive, and in fact may be directly antagonistic to, the interests of other class members.

Indeed, appellant has already demonstrated its inadequacy as class representative in its choice of defendants. If appellant has any claim, it is against its broker, Bartels, and Shaskan, his firm, for it was upon Bartels' oral assurance that Teltronics would be "a great success" that Polak placed primary reliance (J.A. 171). Yet appellant has not named

Bartels as a defendant and has offered no excuse for failing to do so.* The omission is prejudicial not only to appellant's interests, but also to those of other class members, particularly Polak's clients who were also Bartels' clients. Polak has also elected for reasons of his own not to serve his friend and sometime attorney Jeffrey Moross, the former Secretary of Teltronics (J.A. 177-178). Finally, appellant has not named Meyer and Joseph Buchman, the controlling persons of Shaskan. This omission can only be deliberate since, as Polak well knows, the lead underwriter was Shaskan, which is in liquidation.**

The record also reveals that appellant and its counsel should not be permitted to represent any class here for the additional reason, not reached by the court below, that Polak's counsel is concededly and impermissably maintaining him in the prosecution of this lawsuit.

* One may reasonably infer that this decision is related to the fact that Bartels was Polak's broker for a number of years and remains his broker and friend to this day (J.A. 144-145).

** The deliberate decision by a professed class representative (or its counsel) not to name as a party defendant a person against whom not only the purported representative but other class members as well have a claim necessarily creates "a serious conflict of interest" that should in and of itself prove fatal to a finding of adequacy of representation. Adise v. Mather, 56 F.R.D. 4992, 495-96 (D.Colo. 1972). It is unconscionable that Polak, himself intimately involved in the underlying facts of this suit, should determine for the class who should be defendants and who plaintiffs, while at the same time seeking to insulate himself from liability.

Appellant's counsel, Ira W. Berman, stated on the record at Polak's deposition that "the arrangement that I have with Mr. Polak entails the fact that our firm has agreed to take on this litigation purely on a contingent basis with regard to costs, disbursements and fees" (J.A. 223). In a subsequent sworn affidavit, Berman disclosed that he and Polak have had a close professional, business and personal relationship for the last seven years as a result of which Berman has "achieved some substantial financial rewards" and in light of which Berman "saw nothing wrong with [his firm's] pursuing this case on a contingent basis" (S.A. 32).

Polak himself testified that he will not have to pay any of the costs and disbursements of this litigation, even if this litigation is determined adversely to him (J.A. 223, 224). This is the same arrangement that Polak has entered into with this counsel in other class actions arising under the federal securities laws (J.A. 225).* These facts alone are sufficient to warrant class status denial here.

* This case is but one of a series of federal securities laws class actions instituted by or through Polak and his clients wherein Polak and appellant's counsel have collaborated. See, for example, Polak v. Noel Industries, 64 F.R.D. 333 (S.D.N.Y. 1974) brought by Polak's wife and Polak v. California Time Petroleum, et al., wherein Polak himself was the putative class plaintiff (J.A. 103).

ARGUMENT

I.

THIS COURT LACKS JURISDICTION OVER
THE SUBJECT MATTER OF THIS APPEAL

Under the final judgment rule, 28 U.S.C. §1291, only final orders are appealable absent certification pursuant to 28 U.S.C. §1292(b). And, it has been repeatedly held that the denial of a motion for class status is an interlocutory order which, unless so certified or falling within the limited exceptions to this long standing statutory rule, may not be appealed. Parkinson v. April Industries, 520 F.2d 650, 652 (2d Cir. 1975); Milberg v. Western Pacific R.R., 443 F.2d 1301, 1305 (2d Cir. 1971); Caceres v. International Air Transport Association, 422 F.2d 141, 143 (2d Cir. 1970); 7 A Wright and Miller, Federal Practice and Procedure §1802 (1972). Appellant here did not move for certification and there exist none of the exceptional circumstances which have led this Court in the past on a few occasions involving the so-called "death knell" doctrine to permit review of the denial of class status.

While the viability of that rule is open to debate,*

* Judge Friendly in this Circuit has recently concluded that class action appeals should only be permitted pursuant to § 1292(b) certification. Parkinson v. April Industries, supra, 520 F.2d at 660. In addition, the Courts of Appeals for the Third and Seventh Circuits have both recently rejected the death knell doctrine as completely unworkable. See Ungar v. Dunkin' Donuts of America, Inc., 531 F.2d 1211 (3rd Cir. 1976); Anschul v. Sitmar Cruises, Inc., F.2d , 21 Fed.R.Serv.2d 946 (7th Cir., May 17, 1976).

appellees believe that the death knell of this action has not been sounded by the denial of class status, inter alia, because (i) the size of appellant's claims gives substantial financial incentive to continue this suit, (ii) Polak is concededly not paying for the expenses of this suit and can pursue it without any cost to himself, (iii) Polak has strong personal motives for keeping the case alive through appellant, (iv) counter and third-party claims have been asserted against Polak and appellant which guarantee the continuation of this suit, and (v) another putative class representative is seeking at Polak's request to intervene in the court below which may require that the class question be entirely relitigated. In addition, appellant's unique insider status would impel this Court to review the merits of the claims asserted below -- a review consistently found to be impermissible on a class action appeal.

For these reasons,* appellees moved to dismiss this appeal and that motion was referred to this panel without prejudice on November 3, 1976. Appellees' arguments on non-appealability are set forth in full in their motion papers and this Court is respectfully referred to Appellees' Memorandum In Support of Motion To Dismiss Appeal together with the affidavit of Dennis J. Block and accompanying exhibits, all of which are incorporated here by reference.

* For many of the same reasons this Court in Shayne v. Madison Square Garden Corp., 491 F.2d 397 (2d Cir. 1974) declined to review the denial of a class action below on grounds dispositive of this appeal.

Appellant's entire submission in response to the Motion to Dismiss was a four page affidavit requesting only that the appealability issue be deferred. In fact, to date appellant has yet to satisfy its burden to tell this Court why the denial of its class action motion is appealable.

II.

THE COURT BELOW PROPERLY FOUND
APPELLANT TO BE AN INADEQUATE
REPRESENTATIVE OF THE CLASS

Appellant disingenuously implies that appellees somehow tricked the court below into denying class status by inventing counter, cross and third-party claims (App. Br. 4-5).* This deliberate misstatement of the grounds for the decision below ignores the District Court's findings of Polak's insider status as both an advisor to certain putative class members and a possible tippee defendant vis-a-vis other putative class members (Opinion, J.A. 254). In fact, the District Court, after discussing its concern that Polak might "leverage" the class action to protect himself from liability on appellees'

* Appellant's assertion that appellees' counter, cross and third-party claims lack factual underpinning rests on nothing more than self-serving denials of wrongdoing by Polak and Bartels (App. Br. 5) who could hardly be expected to say otherwise (See Opinion, J.A. 256-257.) But the underlying merits of this action are not to be tested on a motion for class status. Dorfman v. First Boston Corp., 62 F.R.D 466, 472-473 (E.D.Pa. 1974); Eisen v. Carlisle & Jacquelin, 479 F.2d 1005, 1015-1016 (2d Cir. 1973). This rule applies to the claims of all parties in a class action. Appellant cannot on the one hand be permitted to go forward with its claims, no matter how spurious, while at the same time requiring appellees to waive their rights to raise claims unless they can immediately offer ultimate proof.

contribution and other claims expressly stated:

"When this potential conflict is considered together with Polak's dual role as class representative and advisor to certain class members, the Court is convinced that Domaco Company is not an adequate class representative." (Opinion J.A. 254-256) (Emphasis supplied.)

The District Court based its decision not simply on the existence of the claims against the Polak defendants, including appellant, but on the fact that Polak's dual role is inimical to the best interests of the class. These claims are surely an aggravating factor because Polak's conduct of this action is now governed not only by his desire to insulate himself from the claims of the putative class members for whom he invested in Teltronics stock, but additionally by his need to protect himself from personal liability arising out of Teltronics' contribution and other claims. It is the existence of these conflicting pressures which the District Court feared would lead Polak to "leverage" the class in order to protect himself.

Appellant's misplaced reliance on Teltronics' claims as being "permissive" rather than "compulsory" also misses the mark (App. Br. 5-6). First, such an argument ignores the District Court's express finding that Teltronics' counter-claim "bears a substantial factual relationship to the claim which Polak seeks to press on behalf of the class" (Opinion, J.A. 255). More importantly, appellant's attempted distinction

is irrelevant to the central conflict issue here. Polak would be subject to the same pressures if Teltronics had commenced a separate suit against him for his use of inside information. This was precisely the circumstance in the G.A. Enterprises, Inc. v. Leisure Living Communications, Inc., 517 F.2d 24 (1st Cir. 1975), relied on by the District Court (Opinion, J.A. 255-256), wherein the parties were engaged in separate litigations. In G.A. Enterprises, the First Circuit, like the court below properly looked to the total relationship between the parties in determining plaintiff's inadequacy to represent the class. It is evident from the cases cited by appellant and discussed infra that Polak has completely misunderstood the necessity for a court to consider the totality of the relationship between a named plaintiff and a defendant in deciding a motion for class status.

A. Appellant's Conflicts With And Different Interests From Those It Purports To Represent Show That Its Claims are Atypical, And That It Is An Inadequate Representative Of Any Class.

It has generally been recognized that the requirements of typicality and adequacy of representation under Rule 23(a)(3) and (a)(4) are virtually the same. See duPont v. Perot, 59 F.R.D. 404, 409-10 (S.D.N.Y. 1973), 3B Moore, Federal Practice, ¶23.06-2. In order to satisfy these requirements, the interests of the representative party must be coextensive with those of the class members he seeks to

represent, and there must be no antagonistic or adverse interests among the representative party and the members of the alleged class.*

Adequacy of representation has assumed "critical importance," 7 Wright & Miller, Federal Practice & Procedure §1765 at 616-617, and "plays a crucial role," duPont v. Wyly, 61 F.R.D. 615, 621 (D. Del. 1973): all members of the class are potentially bound by the judgment unless they affirmatively exercise their option to be excluded from the action, and therefore "the requirements of due process . . . demands assurance that representative parties can be counted upon to faithfully defend the interests of all members of the class." Id. at 621. See also Carroll v. American Federation of Musicians, 372 F.2d 155 (2d Cir. 1967); Hettinger v. Glass Specialty Co., 59 F.R.D. 286 (N.D. Ill. 1973).

It is essential, therefore, that the representative party be one who will assert the members' claims with "forthrightness and vigor," National Auto Brokers Corp. v. General Motors Corp., 60 F.R.D. 476, 486 (S.D.N.Y. 1973); Ruggiero v. American Bioculture, Inc., 56 F.R.D. 93, 95 (S.D.N.Y. 1972). A court must consider "any other fact bearing on the ability of the named party to speak for the

* See, e.g., Vernon J. Rockler and Co. v. Graphic Enterprises, Inc., 52 F.R.D. 335, 340 (D. Minn. 1971); Dolgow v. Anderson, 43 F.R.D. 472, 494 (S.D.N.Y. 1968), rev'd on other grounds, 438 F.2d 825 (2d Cir. 1970).

proposed class," 3B Moore, supra, ¶23.07[1]; duPont v. Perot, supra, 59 F.R.D. at 410; and look "to factors such as the representative's honesty, conscientiousness, and other affirmative personal qualities," so as to assure that the members' rights are certain to be protected. 7 Wright & Miller, supra, §1766 at 634. See also In re Goldchip Funding Co., 61 F.R.D. 592 (M.D. Pa. 1974).

In considering the propriety of class treatment, the courts do not as appellant argues (App. Br. 10-15) require defendants to prove that such conflicts are actual and existing at the time class status is sought. Rather, if there is a reasonable possibility that such antagonism may arise, class action status must be denied. Thus, Judge Tenney, in duPont v. Perot, supra, after setting forth several possible intra-class conflicts which might thereafter arise, denied class status, stating:

"The Court admits that there is no certainty that the events described supra will come to pass. But this Court must consider not only actual conflicts of interests between plaintiff and his purported class, but also the potential conflicts arising from the litigation." 59 F.R.D. at 411 (Emphasis supplied.)

Similarly, the court in duPont v. Wyly, supra, held that the scope of inquiry should encompass "all possible antagonisms," including "any interest which holds the potential of influencing [the] conduct of the litigation in a manner inconsistent with the class" (61 F.R.D. at 623-24). It was pre-

cisely such a potential of leveraging upon which Judge Cannella relied in finding that Polak could not adequately represent the class below (Opinion, J.A. 254-255).

In addition, while it may turn out that only some (or even none) of the initial purchasers of Teltronics stock will assert claims against the Polak defendants, including appellant, it is surely at least a reasonable possibility based on the present record that some or indeed all such purchasers will assert such claims. And, it is manifest that the possibility of the assertion of those claims by class members (many of which have already been asserted by Teltronics) will inevitably influence appellant's conduct of this action.

When presented with considerably less evidence of conflict, courts have consistently refused to permit one in appellant's position to represent a proposed class, particularly where, as here, that party may become the target of claims by potential class members.*

A case typical of those cited to and relied on by the court below is Horwitz v. Panhandle Eastern Pipe Line Co., 293 F. Supp. 1092 (W.D. Okla. 1968) which invol-

* Horwitz v. Panhandle Eastern Pipe Line Co., 293 F. Supp. 1092 (W.D. Okla. 1968); Traylor v. Marine Corp., 328 F. Supp. 382, 385 (E.D. Wisc. 1971). See also Slack v. Stiner, 358 F.2d 65 (5th Cir. 1966); Dave v. Pennsylvania, 344 F. Supp. 1337, 1342-43 (E.D. Pa. 1972) aff'd 483 F.2d 294 (3rd Cir. 1973), cert. denied, 416 U.S. 946 (1974); Johnson v. American General Insurance Co., 296 F. Supp. 802 (D.D.C. 1969).

ved a factual setting similar to that herein. In Horwitz, charges of securities fraud were asserted against an issuer by plaintiffs who were themselves promoters and dealers of the same stock. The court held that those plaintiffs were unfit to represent a class of stock purchasers, some of whom had bought their stock from those promoters, even though the named plaintiffs and the absent class members might have suffered the same injury. The court denied class status because, as here, "these named Plaintiffs may themselves be the target of a 10b-5 action." 293 F. Supp. at 1093 (emphasis supplied). Class treatment is likewise inappropriate here in light of Polak's admitted role as an insider and promoter who advised and caused 50 of his clients to purchase Teltronics stock (approximately 20% of the entire putative class), and the likelihood of class member suits against the Polak defendants, including the named plaintiff.

Traylor v. Marine Corp., 328 F. Supp. 382 (E.D. Wisc. 1971), also cited to the court below, is another case directly in point. There, too, a named plaintiff tried to sue for damages allegedly arising from the sale of a corporation's stock. Even though such a damage claim ostensibly would benefit all shareholders, the court rejected plaintiff as a representative of a class because he was an insider:

[H]is legal relationship to the . . . transactions in question might well make his interest divergent and his rights different from other minority stockholders." 328 F. Supp. at 385 (Emphasis supplied.)

The court below properly found that Polak's legal relationship with many of the class members as investment advisor similarly makes both his (and, necessarily, appellant's) interests and motives divergent from most of the class members. (Opinion J.A. 253-254) The fact is that despite his financial expertise and his research into Teltronics' affairs, Polak made an investment decision which resulted in loss for nearly twenty percent of the members of the class which appellant seeks to represent. Certainly, Polak's admitted control over the Domaco Fund (J.A. 139) protects him from being named as a defendant by Domaco Fund and possibly his other clients, even though he may well share responsibility to his investors for the loss which occurred (See Counter and Cross-Claims ¶¶31-43, J.A. 52-55). Where, as here, such additional motives exist for bringing suit, the courts invariably have denied class status. In this regard, the court in duPont v. Wyly, supra, stated:

" . . . the many faceted relationship between Mr. duPont and UCC suggests that this suit may be an attempt to open still another front in a wide ranging battle having objectives unrelated to those shared by the class. . . . [S]ituations may arise in the course of this lawsuit in which the judgment brought to bear by Mr. duPont could be influenced by considerations

foreign to the interests of the class. For example, if Mr. duPont has a desire to wage war with those who control UCC, he would be less favorably disposed than other members of the class to any overtures of settlement." 61 F.R.D. at 622 (Emphasis supplied.)

Moreover, the District Court correctly relied on the G. A. Enterprises, and Hornreich cases which also control here (Opinion, J.A. 255-257)*. Those cases, like this one, involved suits brought in a representative capacity wherein the controlling plaintiff had interests in the litigation distinct from and potentially contrary to those sought to be represented. Accordingly, those courts cited the same fear of improper leveraging which convinced the court below that Domaco Fund is not an adequate class representative.

Appellant's argument that the G.A. Enterprises and Hornreich holdings are distinguishable because those cases involved conflicting claims existing prior to the commencement of those actions whereas here the claims of conflict were first raised against Polak in this suit has no merit. The question for the Court is what is the total relationship of the parties as it affects the representative litigation? The representative party and the defendants in both of those cases were engaged in several separate actions. Appellees here have

* See G.A. Enterprises, Inc. v. Leisure Living Community, Inc., 517 F.2d 24 (1st Cir. 1975) and Hornreich v. Plant Industries, Inc., 535 F.2d 550 (9th Cir. 1976).

asserted claims against the Polak defendants in the same litigation. The net effect is identical. The potential for the leveraging of the representative action by the real-party-in-interest is such as to preclude the named class representative from adequately representing the putative class.

Courts have also been reluctant to grant class status where, as here, the strength of only some members' "claims [are] mitigated by being vulnerable to [particular] defenses . . . " not available against others. Hettiger v. Glass Specialty Co., supra, 59 F.R.D. at 296; or where, as here, counterclaims may exist against only some of the class members, including the named plaintiff. See Cotchett v. Avis Rent A Car System, Inc., 56 F.R.D. 549, 553 (S.D.N.Y. 1972). See also Alpert v. U.S. Industries, Inc., 59 F.R.D. 491, 499 (D.C. Cal. 1973); Lah v. Shell Oil Co., 50 F.R.D. 198 (S.D. Ohio 1970). As outlined in the Statement of Facts, supra, defenses and counterclaims relating to Polak's conduct and the use or misuse of inside information exist as against both Domaco Fund and all of Polak's other clients who are potential class members.

A case going directly to the issue of Polak's dual role and cited to the District Court is Victorian Investors v. Responsive Environments Corp., 56 F.R.D. 543 (S.D.N.Y. 1972), where the court denied class representative status to one Globus who, like Polak, both purchased stock for himself and caused others to purchase it, possibly incurring liability

to them in the process. The court there, like the court below, held that, Globus, like Polak, had played "the kind of dual role which would make it undesirable for [him] to represent the class of investors." 56 F.R.D. at 547. In denying Globus status as a class representative, the court further cited the fact that as in the present case: "Certain defendants have in fact counterclaimed against Globus for indemnity, claiming that he is primarily liable for any deception of investors or inflation of the market price." 56 F.R.D. at 547.

In the face of the unrebutted factual record and the many cases cited above, appellant incredibly argues that Teltronics has asserted its counter, cross and third-party claims solely to get around language in another recent class action decision, Polak v. Noel Industries, 64 F.R.D. 333 (S.D.N.Y. 1974), involving Polak's wife as the class representative (App. Br. 7)*. Appellant does not reveal that in Noel, unlike here, Polak did not have any involvement in the underlying facts nor did he admit that he had received and relied on information outside the prospectus. Teltronics' claims spring solely from the record here, not from any desire to avoid the result in Noel. Moreover, the decision below is supported by Noel,

* In Noel, as here, Polak was found to be the "moving force" behind the suit (64 F.R.D. at 335).

which expressly recognized that "potential conflicts of interests" and/or "ulterior motives ... will disqualify him or her from representing the class." 64 F.R.D. at 336.

B. The Cases Relied Upon By Appellant
Are Either Inapposite Or Support
Appellees' Contention of Inadequacy.

Appellant has failed to cite a single case to support its unique theory that an insider should be encouraged to bring class actions because "he is a bona fide litigant and not a straw man" (App. Br. 18). Thus, appellant relies heavily on Lamb v. United Security Life Company, 59 F.R.D. 25 (S.D. Iowa 1972) (App Br. 8-9), a case distinguishable from that at bar on almost every point. In Lamb, the court permitted a director who had voted for the merger complained of to be named a representative of the class, finding that he was nothing more than a defrauded individual like other class members. No claims had been threatened or asserted against him individually and the challenged director did not play Polak's dual role of advisor to and representative of certain class members.* Finally, whereas appellant here is the only named class representative, the challenged director in Lamb,

* Cf. Vernon J. Rockler & Co. v. Graphic Enterprises, Inc., supra, cited by appellant (App. Br. 14) where, like Lamb, the challenged class representative did not face any immediate threat of personal liability.

was "only one of a group of plaintiffs seeking to represent the class" (59 F.R.D. at 30). Accordingly, the Lamb court found that if he were later found to be an inadequate representative of the class, "the large number of class representatives appearing herein means that the viability of the class would not be affected by [his] exclusion therefrom." 59 F.R.D. at 31, n. 3.

Appellant's reliance on Mersay v. First Republic Corp., 43 F.R.D. 465 (S.D.N.Y. 1968) and Reichlin v. Wolfson, 47 F.R.D. 537 (S.D.N.Y. 1969) is likewise inexplicable (App. Br. 14). Neither of those cases involved, as here, charges of wrongdoing and/or dual motives by the putative class representative. Those cases stand for the proposition that a class representative cannot be disqualified simply because he is a sophisticated investor -- a ground which appellees have never suggested for disqualifying Polak.*

Appellant cites First American Corp. v. Foster, 51 F.R.D. 248, 250 (N.D. Ga. 1970), for the proposition that a Rule 23 motion can be defeated only where there exists

* Appellant also makes much of the fact that in contrast to Maynard, Merel & Co. v. Carcioppolo, 51 F.R.D. 273 (S.D. N.Y. 1970), Domaco Fund and the rest of the class seek the same type of relief, i.e. money damages, which means, according to appellant, that there is no conflict between them (App. Br. 9-10). The issue in this case, however, is not the type of relief sought, but whether Domaco Fund will seek it in a forth-right manner given Polak's dual role and potential personal liability.

antagonism between the proposed class representatives and absent class members "as to the subject matter of the suit" (App. Br. 11). Thus, according to appellant, Domaco Fund cannot be disqualified as the class representative here because the claims alleged against it relate to after market transactions rather than the alleged prospectus fraud upon which it sues. This line of non sequitur reasoning has consistently been rejected. In duPont v. Wyly, for example, the court found:

"In assessing alleged conflicting interests some courts have stated that 'such antagonism as would defeat the representation of a class must be as to the subject matter of the suit'. . . . I doubt that these courts intended what the plaintiff in this case has read their opinions to say. But in any event, I believe plaintiff's formulation of the rule unwisely attempts to restrict the scope of an inquiry that should encompass all possible antagonisms between the interests of the representative and those of the class." (61 F.R.D. at 623) (Citations omitted)

Likewise, the G.A. Enterprises court stated:

"[I]t is sometimes said that the antagonism of interest 'must go to the subject matter of the suit'. . . . But these principles have not been read to prevent a court from taking account of outside entanglements making it likely that the interests of the other stockholders will be disregarded in the management of the suit." (517 F.2d at 27) (Citation omitted)

Appellant's alternate assertion that it is disingenuous for appellees to oppose a Rule 23 motion on the grounds of its inadequate representation (App. Br. 12),

totally misstates the cases on which it purports to rely. In Umbriac v. American Snacks, Inc., 388 F. Supp. 265, 275 (E.D. Pa. 1975), the court merely acknowledged that "[i]t is in the nature of the motion practice on class determination issues" that defendant's arguments for the best representation of the class have implicit in them a desire to defeat the class. Madonick v. Denison Mines, Limited, 63 F.R.D. 657, 658 (S.D.N.Y. 1974), actually supports appellees' opposition to Polak stating:

"It is well settled that fair representation under Rule 23(a)(4) is questioned only when there are interests within the class which are genuinely antagonistic to each other." (Citations omitted)

An even more startling argument in light of the present record is appellant's suggestion that class status not be denied in limine since the class representative, if later proven inadequate, can be "stripped of its mantel" pursuant to Rule 23(d)(2) (App. Br. 14-15). For a court to grant class status, with all its concomitant expenditure of effort, time and money by both the court and the litigants, knowing full well that a subsequent determination of class representative inadequacy may be inevitable, would subvert every notion of judicial economy. Appellant has not and cannot point to a single case where despite the court's misgivings as to what subsequent proof might reveal about the adequacy of the class representative, a class action was granted on the ground that it

could always be restructured later. The cases cited by appellant for this proposition, Dorfman v. First Boston Corp., supra and In re Goldchip Funding Co., supra, are factually inapposite and recite no such holding.*

Finally, appellant urges that appellees have failed "to show how . . . plaintiff will not adequately protect the interests of the class" citing Cook Investment Co. v. Harvey, 195,203 CCH Fed. Sec. L. Rptr. (N.D. Ohio 1973) (App. Br. 12-13) (Emphasis supplied). This is simply not so. Unlike Cook where the grounds urged for the inadequacy were simply inconsequential,** in this case the District Court has found that Polak plays an irreconcilable dual role as class representative and investment advisor to certain members of the class, and that his conduct of the class action may be leveraged by the fact

* In Dorfman there were two plaintiffs both of whom the court was convinced would provide adequate representation. 62 F.R.D. at 474-475. In Goldchip, where class status was denied on other grounds, the court referred to the possibility of adjusting representation after making a definitive finding that there was no reason to think plaintiffs could have interests antagonistic to the class. 61 F.R.D. at 594, n. 1.

** Defendants contended that one of the plaintiffs showed only a "superficial interest" in the suit, concealed his status as a "market maker" and was related by blood to one of plaintiffs' counsel. The Court held that even if these contentions were true they did not demonstrate plaintiff's disability as a class representative in the face of his ownership of 100 shares of stock and plaintiffs' counsel's apparent expertise in class litigation.

that he faces potential personal liability on a claim "which bears a substantial factual relationship to that which [he] seeks to press on behalf of the class" (Opinion, J.A. 255-256.). It is obvious that just as the court in G.A. Enterprises was concerned as to whether that action would be "pursued, de-emphasized, or settled as the future course of the larger claims might dictate" (517 F.2d at 26), so the Court here must be concerned as to how Polak will react during the future course of a litigation in which at the outset he faces multiple pressures, including the desire to insulate himself from claims by his own clients as well as other class members, and the need to protect himself from potential personal liability on Teltronics' claims for contribution. If he allows this matter to go to trial and Teltronics loses, he may be found liable for contribution. If Teltronics wins, he is open to suit by other members of the class. The probability of Polak's leveraging the class action given this situation is too patent to be ignored, as is the inadequacy of Polak, through Domaco Fund, to adequately represent the class.

III

APPELLANT'S FEE ARRANGEMENT AND CLOSE ASSOCIATION
WITH ITS COUNSEL ACT AS INDEPENDENT REASONS FOR
ITS DISQUALIFICATION AS CLASS REPRESENTATIVE.

Although the District Court did not need to reach the serious ethical questions raised by appellant's relationship with its counsel, this also stands as a separate and independent ground to preclude Polak and his counsel from representing the putative class.

A. Maintenance

It has been generally recognized that unethical conduct on the part of plaintiff's counsel may impair their ability to adequately represent a class under Rule 23(a)(4).

Korn v. Franchard, 456 F.2d 1206 (2d Cir. 1972); Sayre v. Abraham Lincoln Federal Savings & Loan Assoc., 19 F.R. Serv. 2d 311 (E.D.Pa. 1974); Stavrides v. Mellon Nat'l. Bank & Trust Co., 60 F.R.D. 634 (W.D.Pa. 1973); Simon v. Merrill Lynch, Pierce, Fenner and Smith, Inc., 16 F.R. Serv. 2d 1021 (N.D. Texas 1972); Taub v. Glickman, 14 F.R. Serv. 2d 847 (S.D.N.Y. 1970). In the words of one court, "class action status should be denied where counsel's unethical conduct has been or is prejudicial to the interests of the class, or results in creating a conflict of interest between the attorney and the class and the attorney is, therefore, obviously unable to protect the interests of the class." Stavrides v. Mellon Nat'l. Bank & Trust Co., 60 F.R.D. at 636-37.

In this case, the fee arrangement between the putative class plaintiff and its counsel reveals a disabling breach of the Code of Professional Responsibility. Polak and his attorney have testified that appellant will not have to pay the costs and disbursements, including notice to class members, advanced by counsel, no matter what the ultimate outcome of this litigation (J.A. 223-225). Not only is there a confessed expectation on the part of appellant that it will never be called upon to reimburse its attorneys for the costs and disbursements of this action, but there is also an implied admission on the part of appellant's counsel that appellant's ability to bear the costs and disbursements of the action are irrelevant. Indeed, there is no understanding whatsoever on the part of counsel or client that the former will remain ultimately responsible for the costs and disbursements of this litigation. See Eisen v. Carlisle & Jacquelin, 417 U.S. 156 (1974).

A clearer example of maintenance has not confronted a court in the context of a class action. The refusal of our courts to permit a class action where there is even the taint of maintenance is amply illustrated by the recent decision in Frederick Norman, D.D.S., P.C. Employee Pension Fund v. Arcs Equities Corp., F.Supp. , Docket No. 75 Civ. 4391 (S.D.N.Y. July 2, 1976) wherein class status was denied to the named plaintiff pension trust whose alter ego and co-

trustee was bearing the costs of the litigation as a volunteer.

The Court stated

"We are reluctant to permit a plaintiff to conduct litigation as a class representative on the understanding that a related party will voluntarily pay the litigation expenses from time to time as they become due. ... [I]t smacks of Maintenance for a non-party to a lawsuit to pay these legal fees and expenses ... To permit this goes against all the traditions of our jurisprudence." (Opinion at 3) (Emphasis supplied).

How much more egregious is the case at bar where the maintenance is provided not by a lay volunteer, but by appellant's counsel.

The Code of Professional Responsibility promulgated by the American Bar Association in August 1969, and adopted by the New York Bar Association as its own code of ethics, effective January 1, 1970, codifies the obligation of an attorney to maintain the highest standard of ethical conduct. In particular, Canon 5 mandates that a lawyer should exercise independent professional judgment on behalf of a client.

"The possibility of an adverse effect upon the exercise of free judgment by a lawyer on behalf of his client during litigation generally makes it undesirable for the lawyer to acquire a proprietary interest in the cause of his client or otherwise to become financially interested in the outcome of the litigation. . . .

"A financial interest in the outcome of litigation also results if monetary advances are made by the lawyer to his client. Although this assistance generally is not encouraged, there are instances when it is

not improper to make loans to a client. For example, the advancing or guaranteeing of payment of the costs and expenses of litigation by a lawyer may be the only way a client can enforce his cause of action, but the ultimate liability for such costs and expenses must be that of the client. Canon 5, E.C. 5-7 and 5-8 (Emphasis supplied).

There is nothing new in the high obligation of attorneys not to instigate business and expense clients in the interest of business. Prior to the adoption of the Code, members of the Bar were subject to the Canons of Professional Ethics. In particular, Canon 42 provided:

"A lawyer may not properly agree with a client that the lawyer shall pay or bear the expenses of litigation; he may in good faith advance expenses as a matter of convenience, but subject to reimbursement."

As noted in the Preliminary Statement to the Code of Professional Responsibility, the Ethical Considerations, such as those contained in Canon 5, "represent the objectives toward which every member of the [legal] profession should strive." The Disciplinary Rules, however,

"are mandatory in character. The Disciplinary Rules state the minimum level of conduct below which no lawyer can fall without being subject to disciplinary action."

Disciplinary Rule 1-102(A)(1) titled "Misconduct" states that "A lawyer shall not violate a Disciplinary Rule." Disciplinary Rule 5-103(B) titled "Avoiding Acquisition of Interest in Litigation" mandates that:

"While representing a client in connection with contemplated or pending litigation, a lawyer shall not advance or guarantee financial assistance to his client, except that a lawyer may advance or guarantee the expenses of litigation including court costs, expenses of investigation, expenses of medical examination, and costs of obtaining and presenting evidence, provided the client remains ultimately liable for such expenses." DR 5-103(B) (Emphasis supplied).

Thus, the admission of Polak and his counsel that the cost and expenses of this suit have thus far been advanced by counsel and that appellant will not be called upon in the future to repay these amounts or any additional amounts (including the cost of notice to the class) on its face violates both the Canons and Disciplinary Rules governing ethical behavior.

In addition, the contingent fee arrangement between appellant and its counsel violates Section 488* of the New York Judiciary Act, 29 McKinney's Judiciary Law §488 and constitutes a champertous agreement against the public policy of New York.

In the Matter of Gilman, 251 N.Y. 265 (1929) (Cardozo, C.J.); Lawrence v. Commodore Navigation Corp., 108 F.2d 563 (2d Cir. 1940). Gonzalez y Barredo v. Schenck, 287 F.Supp. 505, 527 (D.C.N.Y. 1968). In Gilman, Judge Cardozo said, "[t]here is

* "An Attorney or counselor shall not:

* * *

2. By himself, or by or in the name of another person, either before or after action brought, promise or give, or procure to be promised or given, a valuable consideration to any person, as an inducement to placing, or in consideration

(Continued)

to be no barter of the privilege of prosecuting a cause for gain in exchange for the promise of the attorney to prosecute at his own expense." 251 N.Y. at 270-271. In Lawrence v. Commodore Navigation Corp., supra, the Second Circuit held that an arrangement whereby if there was no recovery, the lawyer would not charge his client anything for his services or for disbursements was within the holding of In the Matter of Gilman and therefore champertous and void.

B. Multiple Clients With Differing Interests

It is also difficult to see how appellant's counsel can reconcile their existing duties to the class representative who may be subject to claims by or liable to members of the class and the duties which they seek to assume on behalf of the absentee members of the class. Cf. Hawk Industries, Inc. v. Bausch & Lomb, Inc., 59 F.R.D. 619, 623-24 (S.D.N.Y. 1973); Ruggeriero v. American Bioculture, Inc., 56 F.R.D. 93, 95 (S.D.N.Y. 1972). Although the absent class members have as yet not asserted claims against the putative class repre-

(Footnote Cont'd.)

of having placed, in his hands, or in the hands of another person, a demand of any kind, for the purpose of bringing an action thereon, or of representing the claimant in the pursuit of any civil remedy for the recovery thereof. . . .

3. An attorney or counselor who violates the provisions of this section is guilty of a misdemeanor." 29 McKinney's Judiciary Law §488.

sentative and Polak, Teltronics has asserted claims which reveal inherent antagonism, conflicts of interest and consequent division of loyalties between the absent class members, which counsel seeks to represent, and counsel's present clients, appellant, Polak, and Equity.

The Code of Professional Responsibility states:

"The professional judgment of a lawyer should be exercised, within the bounds of the law, solely for the benefit of his client and free of compromising influences and loyalties. Neither his personal interests, the interests of other clients, nor the desires of third persons should be permitted to dilute his loyalty to his client." EC 5-1.

This is elaborated in EC 5-14:

"Maintaining the independence of professional judgment required of a lawyer precludes his acceptance or continuation of employment that will adversely affect his judgment on behalf of or dilute his loyalty to a client. This problem arises whenever a lawyer is asked to represent two or more clients who may have differing interests, whether such interests be conflicting, inconsistent, diverse, or otherwise discordant."

Thus,

"[i]f a lawyer is requested to undertake or to continue representation of multiple clients having potentially differing interests, he must weigh carefully the possibility that his judgment may be impaired or his loyalty divided if he accepts or continues the employment. He should resolve all doubts against the propriety of the representation. A lawyer should never represent in litigation multiple clients with differing interests and there are few situations in which he

would be justified in representing in litigation multiple clients with potentially differing interest." EC 5-15, Code of Professional Responsibility.

And Disciplinary Rule 5-105(B) mandates that:

"A lawyer shall not continue multiple employment if the exercise of his independent professional judgment in behalf of a client will be or is likely to be adversely affected by his representation of another client . . ."

Finally, even

"[i]n those instances in which a lawyer is justified in representing two or more clients having differing interests, it is nevertheless essential that each client be given the opportunity to evaluate his need for representation free of any potential conflict and to obtain other counsel if he so desires." EC 5-16, Code of Professional Responsibility.

Based on the record in this case to date, there is a substantial likelihood that Polak and some or all of the putative class members may have "differing interests" as to the future conduct of this litigation. For appellant's counsel to continue to represent the Polak defendants, including plaintiff-appellant Domaco Fund, while simultaneously seeking class status here would appear to directly conflict with the ethical precepts set forth above. With these standards in mind and in light of the long standing relationship between Polak and appellant's counsel,* it is hard to imagine how counsel could advocate for some that which duty to another may require them to oppose for others. The Canons of Professional Ethics, Canon 6.

* See for example, the affidavit of appellant's counsel, Ira W. Berman, detailing his close personal and business relationship with Polak (S.A. 28-33).

IV

APPELLANT CANNOT ESTABLISH THAT COMMON QUESTIONS OF LAW OR FACT PREDOMINATE OVER INDIVIDUAL QUESTIONS AS REQUIRED BY RULE 23(b)(3).

In several recent cases under amended Rule 23, the courts have been reluctant to find a predominance of common questions in a securities fraud context as required by subsection (b)(3) of Rule 23, where oral misrepresentations or omissions are alleged with respect to the class representative.* This was explained by the Advisory Committee in drafting Rule 23(b)(3):

"[A]lthough having some common core, a fraud case may be unsuited for treatment as a class action if there was material variation in the representations made or in the kinds of degrees of reliance by the persons to whom they were addressed. [cases omitted]" Advisory Committee Notes, 39 F.R.D. 69, 103 (1966).

In the instant action, the presence of additional oral representations outside the prospectus and the assurances and guarantees made to the named plaintiff's controlling person, agent and investment adviser serve to insure that in the prospective class action "common questions of fact" would not "predominate over any questions involving only individual members". Rather, questions affecting only Polak and his

* It is clear from the face of Rule 23 that appellant's class, if it exists at all, can be maintained only under subsection (b)(3) and not under either subsections (b)(1) or (b)(2). Indeed, plaintiff only seeks a class determination under (b)(3) (See Pl. Mem. 17).

client-purchasers, including appellant, assume an importance they would not have in a class action brought by a proper representative. These individualized conversations are not the stuff of which class actions are made. In this regard, Judge Lasker recently stated in denying a class motion:

"It is precisely because of the difficulties thus presented that the view that oral misrepresentations and omissions are not suited for class treatment finds strong support in the authorities. . . ." Ingenito v. Bermac Corp., CCH Fed. Sec. L. Rep. 194,548 (S.D.N.Y. 1974), at 95,885.

See also, Skydell v. Mates, CCH Fed. Sec. L. Rep. 193,538 (S.D.N.Y. 1972); Morris v. Burchard, 51 F.R.D. 530, 534-35 (S.D.N.Y. 1971); Moscarelli v. Stamm, 288 F.Supp. 453, 462-63 (E.D.N.Y. 1968).

Moreover, as noted above, an action by the present named plaintiff will involve individual questions of law and fact as to the standard of diligence to be applied to Polak, as an expert; the legal significance of the additional representations obtained from Bartels; the applicability to the named plaintiff and to the other Polak client-purchasers of the defenses and counterclaims relating to inside information, insider trading and non-disclosure; and other similar non-common factual and legal issues. Such questions would not be relevant to an action brought by the majority of the members of the prospective class. Common questions of fact or law therefore would not predominate in a class action brought by this appellant.

Finally, a class action is not superior to other available methods for fair and efficient adjudication of the present controversy if only because of the possible or potential conflict between the interests of the class as a whole and the interests and attitudes of appellant and the other Polak defendants, as set forth above, "attitudes which reveal that a class action may be neither fair to the other members of the class nor efficient for the resolution of their possible claims." Maynard, Merel & Co. v. Carcioppolo, supra, 51 F.R.D. at 279.

CONCLUSION

For all of the foregoing reasons the Order appealed from should be affirmed in all respects.

Dated: New York, New York
December 15, 1976

Respectfully submitted,

WEIL, GOTSHAL & MANGES
Attorneys for Appellees
Teltronics Services, Inc.
Edward M. Beagan, David A.
LaConte, Gerard F. Hug and
Gilbert Monick
767 Fifth Avenue
New York, New York 10022

Of Counsel:

Dennis J. Block
James W. Quinn
Lynn H. Schafran

Copy Set
Bennet and Bryant
17/3/76